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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

November 30, 1999

VIA HAND DELIVERY

Ms. Magalie Roman Salas
Office of the Secretary
Federal Communications Commission
Room TW-A324
445 Twelfth Street, SW
Washington, D.C. 20554

Re: Access Charge Reform, CC Docket 96-262; Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1; Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers, CCB/CPD File No. 98-63; Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA, CC Docket No. 98-157

Dear Ms. Salas:

Pursuant to the Fifth Report and Order and Further Notice of Proposed Rulemaking in the above-captioned matter, enclosed please find an original and ten copies of the Reply Comments of the Ad Hoc Telecommunications Users Committee.

If you have any questions regarding this filing, please do not hesitate to call me at (202) 857-2550.

Sincerely

Betsy M Eisen

Betsy Eisen
Legal Assistant

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)
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	)
Price Cap Performance Review for Local Exchange Carriers	) CC Docket No. 94-1
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Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA	) CC Docket No. 98-157

REPLY COMMENTS OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

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November 30, 1999

SUMMARY

In their comments responding to the *FNPRM*, the price cap LECs unanimously (and predictably) oppose the *FNPRM*'s proposals to increase the "g" factor in the common line basket PCI formula to full "g"; to introduce an analogous "q" factor to the PCIs for the traffic-sensitive and trunking baskets; to make one-time adjustments restating these PCIs to reflect adoption of the proposed "g" or "q" factors; and to replace certain per-minute charges for switched access with a capacity-based rate structure. None of the objections raised by the price cap LECs is meritorious.

To buttress the industry's position, USTA proffers an analysis by Dr. William Taylor. Dr. Taylor's analysis is a full-scale assault on the Commission's proposals, which Dr. Taylor mistakenly construes as proposals prompted by the Commission's unwarranted concern over the price cap LECs' high interstate earnings. In this reply, Ad Hoc demonstrates the continuing relevance of LEC interstate earnings due to the significant links between rates and costs under existing price cap regulation and the insufficient level of competition that has emerged to date in LEC interstate markets.

Contrary to Dr. Taylor's protests, the Commission's proposals do not represent "unpredictable and opportunistic adjustment[s]." To the contrary, as explained in Ad Hoc's comments, the Commission's proposals reflect well-reasoned adjustments whose implementation is long overdue in the context of ensuring effective ongoing regulation of the price cap LECs and promoting economic efficiency gains that will ultimately benefit consumers and carriers alike.

These reply comments also demonstrate that Dr. Taylor's defense of the high interstate earnings levels enjoyed by the price cap LECs is without sound economic

foundation. The LECs' high earnings have not been produced solely by the LEC's own "skill or stupidity," as Dr. Taylor puts it, but also as the direct result of economic growth beyond the LECs' control and long-standing imperfections in the current price cap mechanisms. The Commission's proposals to fine tune the price cap rules to promote economic efficiency in interstate access markets and to produce outcomes more consistent with competitive market levels are justified, albeit belated, notwithstanding the loud protests mounted by the price cap LECs.

Ad Hoc recognizes, as pointed out by some of the LECs, that certain inherent inefficiencies in the Commission's rules may be phasing out, *e.g.*, those relating to per minute charges for common line costs. Ad Hoc also acknowledges that other inefficiencies -- for example, those relating to local switching costs that do not tend to increase with growth in traffic volumes – may be difficult to measure precisely. However, these considerations neither negate the existence of these fundamental inefficiencies nor provide valid reasons to abandon the Commission's proposals to modify the PCIs or other reasonable alternatives such as AT&T's proposed revenue per line cap for the common line basket.

While there appears to be little support for the Commission's proposal to replace the current system of per minute charges for the traffic-sensitive basket with a more efficient trunk-based rate structure, the inclusion of a "q" factor in the PCI for this basket to account for the remarkable growth in traffic volumes is appropriate under either rate structure. Should the Commission determine that a capacity-based approach is infeasible at this time, that determination would only reinforce the need to apply a full "q" factor to the traffic-sensitive basket.

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REPLY COMMENTS OF THE
AD HOC TELECOMMUNICATIONS USERS COMMITTEE

The Ad Hoc Telecommunications Users Committee ("Ad Hoc" or the "Ad Hoc Committee") submits these Reply Comments in response to the Commission's Fifth Report and Order and Further Notice of Proposed Rulemaking in the above-captioned proceeding ("*FNPRM*")[1].

INTRODUCTION

The price cap LECs unanimously oppose the *FNPRM's* proposals to increase the "g" factor in the common line basket PCI formula from "half g" to "full g"; to introduce an analogous "q" factor to the PCIs applicable to the traffic-sensitive and trunking baskets;

1 *Access Charge Reform* (CC Docket No. 96-262), *Price Cap Performance Review for Local Exchange Carriers* (CC Docket No. 94-1), *Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers* (CCB/CPD File No. 98-63), *Petition of US West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA* (CC Docket No. 98-157), Fifth Report and Order and Further Notice of Proposed Rulemaking, FCC 96-206, rel. Aug. 27, 1999 ("*FNPRM*").

and to make one-time adjustments restating these PCIs to reflect adoption of the proposed "g" or "q" factors. The LECs advance a number of different arguments in opposition to these proposals, most of which rely on or reference explicitly the Attachment to USTA's Comments authored by Dr. William Taylor.[2] Accordingly, Ad Hoc's reply comments focus largely on responding to Dr. Taylor's analysis. While the analysis Dr. Taylor presents is extensive, as discussed below, it is also conceptually unsound and accordingly provides no basis for the Commission to abandon its efforts to correct the economic inefficiencies and fundamental imbalances in the existing price cap formulations.

DISCUSSION

A. ARGUMENTS ADVANCED BY PRICE CAP LECS IN OPPOSITION TO COMMISSION PROPOSALS FOR THE "G" FACTOR, "Q" FACTOR, AND RELATED ONE-TIME ADJUSTMENTS TO THE PCIS ARE WITHOUT MERIT.

Dr. Taylor's analysis develops a number of arguments in support of the LEC position that changes to the PCIs as proposed in the *FNPRM* are inappropriate, key among which are:

- The existence of high interstate regulatory earnings (represented by Dr. Taylor to be a principal motivating factor behind the Commission's proposed PCI changes) is not a sign of a problem.
- There is no evidence to suggest LECs have experienced a windfall under the existing price cap formulation.
- The manner in which the X factor has been computed precludes the existence of a windfall.

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[2] USTA Comments at 2-3; *see also e.g.* Bell Atlantic Comments at 5-12, GTE Comments at 39-44, and SBC Comments at 3. (All citations to comments below refer to comments filed in response to the *FNPRM*.)

- There is no justification for any growth factor in any of the PCI formulas, including the existing g/2 in the common line PCI.

As discussed below, the arguments advanced by Dr. Taylor are without merit.

B. INTERSTATE REGULATORY EARNINGS REMAIN RELEVANT UNDER PRICE CAP REGULATION

Dr. Taylor not only discounts the relevance of the LECs' high interstate regulatory earnings but also suggests that the existence of high earnings is a good thing to observe under price caps regulation.[3] Dr. Taylor's arguments are invalid under existing market and regulatory conditions for price cap LECs.

Contrary to Dr. Taylor's assertion, high interstate regulatory earnings are relevant to an assessment of the price caps rules for at least two reasons. First, as the Commission acknowledged in its *Depreciation Forbearance Notice*,[4] the Commission's price cap plan preserves a number of significant linkages between rates and costs, keeping regulated earnings relevant as a practical matter, regardless of the theoretical de-linking of rates and costs associated with price caps regulation.[5] One of the most significant of these remaining linkages is the calculation of a low-end adjustment and the ability of LECs to make a takings claim under the Fifth Amendment.[6]

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3 Comments of William E. Taylor , Ph.D., Attachment to USTA Comments ("Taylor"), at 12-13.

4 *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers* (CC Docket No. 98-137), Notice of Proposed Rulemaking, FCC 98-170, rel. Oct. 14, 1998 ("*Depreciation Forbearance Notice*").

5 *Id.* at ¶ 6.

6 Linkages identified in the Commission's *Depreciation Forbearance Notice* include: (1) the calculation of a low-end adjustment; (2)the recalculation of the productivity factor; (3) the determination of an exogenous cost adjustment; (4) the calculation of the Base Factor Portion that is used to determine how much a carrier can recover through End User Common Line charges; (5) the determination of the cost support a carrier would have to provide if it proposed an Actual Price Index higher than its Price Cap Index; (6) the effects on prices or federal support payments in connection with new mechanisms created to implement the Telecommunications Act of 1996, for example, in the determination of forward looking costs used for calculating universal service support or rates for interconnection and unbundled network elements; and (7) takings claim under the Fifth Amendment. *Id.*

Ironically, in the instant proceeding, the price cap LECs themselves argue forcefully for the retention of the low-end adjustment mechanism as a means of preserving the LECs' constitutional right to earn a fair rate of return. Yet the low-end adjustment is a mechanism specifically tied to the very interstate regulated earnings that Dr. Taylor so categorically states should not be the basis for any Commission decisions. GTE could not have been more explicit in staking out the LEC claim to rate of return guarantees, notwithstanding the perverse impact that such guarantees have on the incentives supposedly created under price cap regulation. According to GTE,

> [w]hen devising rules to regulate a carrier's rates, the Commission must ensure that a company is guaranteed under the rules the opportunity to earn a rate of return that fairly compensates the company. As the Commission is well aware, this is constitutionally required by the Fifth Amendment.[7]

But as Ad Hoc has consistently argued before the Commission, in this proceeding and others, the LECs cannot be allowed to have it both ways, *i.e.*, receive guaranteed recovery of regulated investment and, at the same time, be given unfettered regulatory freedom to maximize earnings.[8] In the current context, the price cap LECs cannot consistently advocate a right to rate of return-based income guarantees, like the low-end adjustment based upon interstate regulated earnings results, while at the same time asserting (as Dr. Taylor does on their behalf) that the Commission has no grounds to base decisions in this docket on the continuing presence of high regulatory earnings.

The very existence of the low-end adjustment mechanism is at odds with Dr. Taylor's statement that "price cap regulation only makes sense if the regulated firm is financially exposed to the full range of market outcomes produced by its skill or

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7 GTE Service Corporation, Petition for Reconsideration of Fifth Report and Order, filed Oct. 22, 1999 at 4, in CC Docket No 69-262.

8 *See FNPRM* at ¶ 164, *citing* Ad Hoc Comments at 66-69.

stupidity."[9] Indeed, any incentive-blunting impacts that may legitimately be claimed for the Commission's proposed changes to the PCI formulas are inconsequential in comparison with those that result from the continuation of the low-end adjustment.

Dr. Taylor's argument that the inability to accurately measure regulatory earnings precludes regulators from using those earnings as a source of meaningful information about a firm's performance is similarly hypocritical. Apparently, none of the imperfections detailed by Dr. Taylor are significant enough to undercut LEC support for continuing the low-end adjustment mechanism, which is based on those same, supposedly unreliable earnings measures, or the LECs' takings claims under the Fifth Amendment, similarly based on regulatory earnings measures. Of course, the recent stellar financial performance of the LECs under price caps makes a low-end adjustment or a takings claim so unlikely that the LECs' willingness to assail, through their expert, measures of regulatory earnings is entirely understandable.

While there certainly are problems with measuring regulatory earnings, those problems are not nearly so significant as Dr. Taylor suggests. *Any* measurement of earnings, whether regulatory or financial, is an inherently problematic undertaking. More to the point, however, separations and other rules of regulatory accounting have historically been, and remain, an integral part of both the Commission's regulation of interstate telecommunications, and as GTE so stridently reminds us, the constitutional protection of LECs' rights under the Fifth Amendment.[10]

The second major reason why high earnings do remain a relevant concern under price cap regulation is that the market is not sufficiently competitive to constrain the

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9 Taylor at 12-13.

LECs from earning supranormal LEC profits.[11] Without a sufficiently competitive market to constrain above-cost pricing, high earnings cannot be ascribed solely to the LECs' increased efficiency or superior marketing skills, as Dr. Taylor would suggest. Rather, high earnings are as likely, indeed more likely, to be the result of an inefficient rate structure combined with traffic volumes increasing for reasons beyond the LECs' control or influence. Under these far less than ideal competitive conditions, increased earnings under price cap are not a sign of success, nor are customers getting the benefit of lower prices of a magnitude consistent with competitive market conditions.[12]

While it is true, as Dr. Taylor describes, that firms performing above the average productivity level will earn more than those performing below the average, earnings for price cap LECs are high across the board. Moreover, Dr. Taylor provides no evidence showing a relationship between high LEC earnings and the productivity performance of specific LECs. Furthermore, in a competitive market, such above-average earnings would not be sustainable over time, as they have been for the price cap LECs.

C. THE COMMISSION'S PROPOSED CHANGES ARE DESIGNED TO INCREASE MARKET EFFICIENCY CONSISTENT WITH OPERATIONS OF A COMPETITIVE MARKET AND ARE NOT DIRECTLY TIED TO REGULATORY EARNINGS.

Significantly, unlike the low-end adjustment, the Commission's proposed changes to the PCI are not directly tied to regulatory earnings. The Commission merely cites high LEC regulatory earnings as evidence of the underlying phenomenon that the Commission's proposed changes are designed to correct. This phenomenon is a per-minute rate structure which is misaligned with underlying cost causation and, in

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10 *See supra* note 7 and text accompanying.

11 *See FNPRM* at ¶¶ 2-4; *see also Depreciation Forbearance Notice* at ¶ 7.

conjunction with high growth in traffic volumes, unfairly rewards LECs vis-à-vis IXCs and end user customers, resulting in market inefficiencies.

The purpose of the proposed PCI changes, unlike the low-end adjustment, is not to produce a specific earnings result. Rather, the purpose is to produce a more efficient market and regulatory outcome consistent with a competitive market result.[13] The Commission very cogently describes the important interrelationship between the productivity factor and efficiency in its recent X Factor Further Notice of Proposed Rulemaking.[14] As explained by the Commission, if the X factor is set too low, then prices will be set too high, and "end users will purchase less of the services produced, and the quantity of output will be lower than if prices were set at a competitive level."[15] While the Commission in the X Factor Further Notice was specifically talking about the consequences of an erroneous TFP calculation, an erroneous PCI calculation (such as that resulting from the failure to capture growth effects properly) has the very same consequences on prices, output, and efficiency.

Dr. Taylor talks (incorrectly) about the PCI changes proposed in the *FNPRM* as if their implementation was no different from an explicit requirement for the LECs to share earnings.[16] In doing so, Dr. Taylor is creating a straw man that he can readily attack, but that has no relevance to the changes proposed in the *FNPRM*. Those PCI changes differ from earnings sharing both as to their form and their substance. Thus, adoption of

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12 Taylor at 12.

13 *See FNPRM* at ¶ 6.

14 *Price Cap Performance Review for Local Exchange Carriers* (CC Docket No. 94-1) and *Access Charge Reform* (CC Docket No. 96-262), Further Notice of Proposed Rulemaking, FCC 99-345, rel. Nov. 15, 1999 ("*X Factor FNPRM*").

15 *Id.* at ¶ 14

16 Taylor at 13.

the proposed PCI changes does not remotely constitute a "return to earnings-based regulation," as Dr. Taylor avers.[17] If anything, those changes are designed to result in the realization of market efficiencies consistent with a competitive market model so as to hasten the day when competitive, rather than regulatory, forces can prevail.

D. INDUSTRIAL EARNINGS BASED ON FINANCIAL REPORTING DATA ARE IRRELEVANT TO AN ASSESSMENT OF LEC EARNINGS BASED ON REGULATORY REPORTING DATA

For the reasons discussed above, the high interstate earnings of price cap LECs are a powerful and probative indicator of a problem with the existing price cap rules. Dr. Taylor attempts to dismiss this evidence by comparing LEC earnings with a "control group" of Value Line industrials.[18] This comparison is misleading and invalid.

Dr. Taylor asserts that the U.S. non-farm business sector is "a reasonable control group for the price cap LECs" because of "the use of the performance of this sector in the price cap plan." [19] He then uses the Value Line Industrial I Composite, which consists of 875 industrial, retail, and transportation companies, as a proxy for the performance of the non-farm sector.[20]

Neither the non-farm business sector, as a general proposition, nor the Value Line Industrial I Composite, in particular, is a reasonable control group for the price cap LECs for two reasons. First, as Dr. Taylor himself notes, there are significant differences between regulatory and financial reporting that make such comparisons invalid. At a minimum, when comparing price cap LEC income to that of non-regulated

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17 *Id.* at 16.

18 *Id.* at 15.

19 *Id.*

20 *Id.*

companies, LEC financial reporting data should be used, not regulatory data. Second, the use of the non-farm sector in the productivity formula is in the context of measuring the *differential* productivity of the LECs versus the broader economy as a whole. The formula is not based on an assumption that LEC operations are comparable to the operations of these firms. Quite the contrary, the use of the non-farm sector in the productivity formula is based on the threshold assumption they will be different.

E. THE PRICE CAP FORMULA HAS FAILED TO CAPTURE THE MISALIGNMENT BETWEEN USAGE AND COSTS INHERENT IN THE ACCESS CHARGE RATE STRUCTURE.

Dr. Taylor asserts that using either the indirect (historical price) approach or the direct TFP approach to measuring the X factor "precludes any windfall from occurring [under the existing rules] as long as growth rates captured in the historical period persist in the future."[21] As discussed below, Dr. Taylor's analysis is flawed in a number of important respects.

As to the indirect (historical price) approach, Dr. Taylor claims that an X factor developed using this method would preclude the price cap LECs from experiencing an earnings windfall. As Dr. Taylor himself points out, this claim is only true "as long as the initial rates at the outset of the price cap plan were determined to obtain zero excess profit, and the relative growth rates of minutes and lines (TS and NTS cost elements) during the study period used to determine the X factor remain the same during the period in which X is applied in the price cap index formula."[22] Neither of these conditions, which Dr. Taylor brushes off as simple conditions to be met in order for his premise to remain valid, are in fact satisfied, rendering Taylor's argument invalid.

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21 *Id.* at 17.

First, the indirect method calculated an X factor that would simply yield, if applied for the duration of the study, the contemporaneous rate of return of 12%. This method does not, as Dr. Taylor suggests, necessarily eliminate all excess profit. While this rate of return was the prevailing rate under rate-of-return regulation, because it was a fixed rate, it would not necessarily preclude the price cap LECs from enjoying excess profits over the entire time interval covered by the indirect study.

Indeed, the Frentrup-Uretsky study, which Taylor cites for the indirect approach, made clear that "the value of X is very sensitive to both the time period chosen for the starting pint of the analysis and to changes in the formula used for the price cap index (PCI)".[23] The reason the choice of time period has such a great effect is that conditions in the telecommunications industry are changing rapidly. Because of these rapid changes, it would be naïve and unreasonable to assume that an X factor developed through the indirect method would remain capable of precisely constraining excess profits to zero as required under Dr. Taylor's argument.

Dr. Taylor's reliance on the second of his two conditions (*i.e.,* that the relative growth rates of minutes and lines remain constant or decrease during the period in which the X factor is applied), is misguided because a minutes to lines growth rate relationship on its own is not a reliable basis for evaluating the ability of the LECs to earn excess profits under price cap regulation. Rather, the Commission must examine the growth of traffic-sensitive revenue in relation to the non-traffic sensitive costs they are intended to recover. For example, even where the growth rate for minutes per line

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22 *Id.* at 18.

23 *Policy and Rules Concerning Rates for Dominant Characters,* CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990), Appendix C, *A Study of Local Exchange Carrier Post-Divestiture Switched Access Productivity* by J. Christopher Frentrup and Mark I. Uretsky at 1.

is decreasing, the LECs still enjoy a revenue windfall so long as the revenue increase caused by even a reduced growth in minutes exceeds the cost increase associated with the growth in total lines. This condition has occurred whenever a large portion of line growth resulted from the installation of additional lines which carry with them a much lower incremental cost to the LECs than do primary lines.[24]

Dr. Taylor attempts to demonstrate that if the growth in minutes per line stays constant, then the LECs will not generate any excess profits. However, this calculation fails to take into account changes in underlying costs occurring over the life of the plan. For example, if the unit costs of the lines themselves should drop due to an increasing proportion of second line growth, and the LECs are still allowed to charge per-minute prices based on an X factor that was calculated based on the old higher costs, the LECs will be handed an opportunity to earn excess profit. And in fact, this is just what has occurred in the telecommunications industry, as an increasing proportion of the growth in telephone lines in the past decade is attributable to second lines.[25]

As to the direct TFP approach, Dr. Taylor's analysis is also overly simplistic and does not comport with the reality facing LECs under the Commission's price cap plan.

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[24] According to Bell Atlantic's CEO Raymond Smith, "[i]n 1995, sales of secondary lines at Bell Atlantic increased more than 50 percent, fueled by surging demand for Internet and telecommuting applications. Unlike traditional horizontal line growth, which would have significantly added to our capital expenditures, the vertical growth we experienced in '95 brought most of the revenues down to the bottom line. *That's because we were able to provision new lines and services from idle capacity in existing plant.*" Raymond F. Smith, Speech at the Merrill Lynch Telecommunications CEO Conference (Mar. 19, 1996) (*emphasis added*).

[25] In 1988, the percentage of additional lines for households with telephone service was approximately 3%, by 1997 that number had jumped to approximately 19% (Trends in Telephone Service, Industry Analysis Division - Common Carrier Bureau -Federal Communications Commission, September 1999, Table 20.4). Additional evidence from individual LECs confirms this growing importance of additional line sales. For example, SBC reports that the number of access lines increased by 4.3% and 5.1% in 1998 and 1997. Of this growth, approximately 40% and 31% of access line growth in 1998 and 1997 was due to sales of additional access lines to existing residential customers. SBC Communications, Inc., *SBC Communications, Inc. 1998 Annual Report* (last visited Nov. 29, 1999) <http://www.sbc.com/Investor/Financial/Annual/Report/Home.html>.

According to Dr. Taylor, any changes in relative growth between switch inputs and switch outputs would be captured in the TFP analysis.[26] While relative growth changes could theoretically be captured in the TFP analysis, if the TFP was recalculated at very frequent (if not real time) intervals, this is simply not the case under the Commission's current price cap plan.

Under the Commission's plan, the TFP once calculated, remains fixed until the next review period. These review periods have been rather infrequent over the course of the LEC price cap plan. Under these circumstances, changes in relative growth are simply not captured in the manner Dr. Taylor opines.

Indeed, as Dr. Taylor himself highlights in his reference to the Commission's PCI adjustment in the *LEC Price Cap Performance Review*,[27] correction for any windfall in earnings by the price cap LECs requires discrete action on the part of the Commission. In particular, the Commission must take action to restate PCIs reflecting erroneously low historical X factors. While it is true that the Commission already made one such correction in the past, that fact alone does not, as Dr. Taylor implies, constitute evidence that no windfall exists at the present time. Rather, as the Commission correctly concludes, that one correction was not sufficient and further corrective action is required to reconcile the Commission's use of a fixed TFP in a unusually dynamic, fast-growing industry.

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26 Taylor at 20.

27 *Id.* at 20-21.

F. THE RECORD JUSTIFIES THE INCLUSION OF GROWTH FACTORS IN THE PCI FORMULAS

As discussed above, the X factor does not capture changes in relative growth in a manner that precludes windfall profits by the price cap LECs. Dr. Taylor notes that the Commission previously sought comment on the possibility that growth would be double-counted if the rules used both a TFP-based productivity factor and a separate growth factor in the PCI formula.[28] However, as noted in the *FNPRM*, the Commission's primary concern over the possibility of double-counting was in connection with the adoption of a moving average TFP, a concept rejected by the Commission in the *LEC Price Cap Performance Review Order*.[29] As long as the inherent misalignment between rate structure and underlying costs exists in access charge tariffs, and as long as the PCIs used to set access charge rates embody that misalignment, the basic market inefficiency described above will exist; prices will be set too high and the quantity of output ultimately purchased by end users will be lower than if prices were set at a competitive level.

In order to fix this problem, the Commission must take two steps. First, the Commission must either revise the access rate structures so that non-traffic sensitive costs are not recovered through usage-based charges, or *at a minimum* include factors that account for usage growth in all PCI formulas applicable to services for which this

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[28] *Id.* at 22, *citing Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1 Fourth Report and Order and *Access Charge Reform*, CC Docket No. 96-262, Second Report and Order, 12 FCC Rcd at ¶¶ 169-170 ("*Price Cap Performance Review Fourth Report and Order*").

[29] *See FNPRM* at ¶ 227, *citing Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd at 9079-80; ; *Access Charge Reform* (CC Docket No. 96-262), *Price Cap Performance Review for Local Exchange* Carriers (CC Docket No. 94-1), *Transport Rate Structure and* Pricing (CC Docket No. 91-213), *End User Common Line* Charges (CC Docket No. 95-72, First Report and Order, 12 FCC Rcd at 16027-28; *Price Cap Fourth Report and Order*, 12 FCC Rcd at 16709-10.

rate/cost misalignment occurs. Second, the Commission must adjust current PCIs to levels that would have existed had the corrections identified been made since the outset of price cap regulation. Otherwise, the market efficient outcomes desired by the Commission will not be realized.

Ad Hoc recognizes, as do a few of the LECs,[30] that certain inherent inefficiencies in the Commission's rules may be phased out, *e.g.*, those relating to per-minute charges for common line costs. Moreover, inefficiencies relating to local switching costs that do not tend to increase with growth in traffic volumes may be difficult to precisely measure. However, these considerations neither negate the existence of these fundamental market inefficiencies nor provide valid reasons why the Commission's proposals to modify the PCIs (or other reasonable alternatives such as AT&T's proposed revenue per line cap for the common line basket) should not be adopted.

G. THE COMMISSION SHOULD ESTABLISH UNIFORM, CAPACITY-BASED RATE STRUCTURES FOR SWITCHING

The Commission's *FNPRM* sought comment on the merits of changing the existing per-minute rates for the local switching and tandem switching portions of switched access service to a capacity-based rate structure in order to more closely track the manner in which switching costs are actually incurred.[31] In its Comments, Ad Hoc supported capacity-based switching charges in principle, but recognized that it might prove quite difficult to quantify the cost-capacity relationship for the shared facilities whose costs are currently recovered through the per-minute local switching charge.[32]

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30 GTE Comments at 38; SBC Comments at 3.

31 *FNPRM* at ¶¶ 211-216 and 223-225, respectively.

32 Ad Hoc Comments at 10.

While the concept of capacity-based charges also received support from another user party, the General Services Administration,[33] the LECs and IXCs expressed numerous concerns and objections to the concept, and described several implementation issues that would impede development of sound capacity-based local switching charges. The carriers contend, for example, that switch capacity requirements are not driven exclusively by interstate access demand, but by the aggregation of demand for all services using local switching;[34] that transitioning to a capacity-based rate structure would disrupt the business plans of LECs and IXCs alike;[35] and that a new rate structure would require development of costly tracking and billing capabilities for local switching, while existing per-minute tracking and billing could not be eliminated.[36] In addition, USTA's economic consultant, Dr. Taylor, questioned the appropriateness of capacity-based local switching charges on economic grounds, contending that that the FCC's proposed capacity-based rate structure "is merely another way to recover the same traffic-sensitive switch costs on a basis which, in the long run, remains traffic sensitive."[37] No carriers' initial comments contained a concrete proposal for how such capacity-based charges should be devised, and few responded directly to the Commission's request for comments on specific implementation issues, such as evidence concerning the appropriate DS-3 to DS-1 ratio for trunking.[38]

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33 GSA Comments at 9-10.

34 *See, e.g.,* AT&T Comments at 14-15 and GTE Comments at 30.

35 Bell Atlantic Comments at 3.

36 US West Comments at 9.

37 Taylor at 7.

38 *FNPRM* at ¶ 214. One exception is AT&T, which indicated that the DS-3 to DS-1 rate relationship should be less than 28:1, although it did not recommend a specific ratio. AT&T Comments at 15-16.

Ad Hoc believes that some of the carriers' objections to the adoption of a capacity-based rate structure are overstated. For example, while it is true that interstate switched access is only one of several services that jointly comprise the total demand confronting a given local switch, the intrastate switched access tariffs of the major LECs frequently mirror their interstate rate structures, and in some cases, state PUCs require switched access rates to be imputed into LECs' intrastate toll rates. Consequently, if the Commission were to adopt capacity-based switching charges for interstate switched access, a larger proportion of total switching demand might reflect capacity-based rates than the carriers have assumed.

Similarly, Dr. Taylor's observation that capacity-based charges amount to another form of traffic-sensitive cost recovery is so over-broad as to be effectively meaningless: Dr. Taylor might just as well contend that both seconds and years are measures of time, so that there is no reason to choose one over the other for a given purpose. Of course, the relevant question is whether capacity-based charges would be able to more accurately track changes in switching costs over time than do per-minute charges, which would increase the efficiency of the switched access rate structure.

Given the lack of support by the LECs and IXCs, the Commission's proposal to establish mandatory capacity-based switching charges could be delayed or stymied. As an alternative, some LECs propose that the Commission should allow them to adopt capacity-based switching charges on an elective basis, using rate structures that they determine unilaterally.[39] Ad Hoc continues to believe that any rate structure revisions should be adopted on a uniform basis, for the reasons we provided in our initial

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[39] USTA Comments at 10; SBC Comments at 2.

Comments.[40] We observe that AT&T also recognizes the importance of ensuring that there is a consistent, nondiscriminatory rate structure applied by all LECs.[41]

In any event, the Commission should not lose sight of the basic objective that motivated the Commission's proposal for capacity-based switching charges, which was to improve the economic efficiency of the switched access rate structure by correcting the existing problem of recovery of non-traffic sensitive costs through traffic-sensitive charges.[42] Because this underlying rationale remains valid, any long-term deferral of a decision to implement a capacity-based approach would only reinforce the need to apply a full "q" factor to the traffic-sensitive basket as an alternative means to accomplish the same result.

CONCLUSION

For the foregoing reasons, the Commission should adopt the proposed changes to the PCI formulation for the common line, local switching, and trunking baskets as set forth in the *FNRPM*, notwithstanding the self-serving opposition of the LECs. The proposed PCI changes will enhance economic efficiency in access charge markets. The key issue here is not, as Dr. Taylor describes it, dividing the benefits of growth between IXCs and LEC shareholders,[43] but rather making the corrections needed to bring carrier rates and

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40 Ad Hoc Comments at 13.

41 AT&T Comments at 16.

42 *FNPRM* at ¶ 208.

43 Taylor at 24.

end user demand to levels consistent with a competitive market result. These corrections are long overdue and should be implemented as set forth in these Reply Comments.

Respectfully submitted,

AD HOC TELECOMMUNICATIONS USERS COMMITTEE

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November 30, 1999

Certificate of Service

I, Betsy M. Eisen, hereby certify that a true and correct copy of the preceding Comments of the Ad Hoc Telecommunication Users Committee was served this November 30, 1999 via hand delivery upon the following party:

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November 29, 1999

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